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Recommended Citation
REGULATING THE GLOBAL BANKING NETWORK—WHAT ROLE (IF ANY) FOR THE IMF?*

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As one who has grown up with the IMF\(^1\) and who has spent many frustrating hours trying to understand it, I welcome the opportunity to address a learned and interested audience about an organization that has had such an important impact on the development of international economic law.\(^2\) Rather than eulogize the Fund for its accomplishments, however, I prefer to celebrate the institution by focusing critically on its ability, at age fifty, to fulfill the goals for which it was established. I have selected two of these goals—exchange rate stability and the promotion of a liberal payments regime—and will address the IMF's abilities to achieve them under current conditions of global banking and relative freedom of capital movements.

The specific subject that I have chosen is the IMF's role in regulating the global banking network, that increasingly pervasive web of private international banks and investment firms that links national economies throughout the world. This subject should give you pause—since when does the IMF have a role in regulating international banking? The IMF deals with central banks, not private banks. Its relationship to the latter is so indirect as to be virtually non-existent.

My central thesis is that the IMF can no longer afford the luxury of ignoring the operations of the international financial industry to the extent that it has in the past. International banking and capital markets have grown significantly since the IMF was founded. Over the past twenty years, international banking activity has expanded at an annual rate that is approximately twice the rate of growth in world trade and world output.\(^3\) As we shall see, the IMF recognizes the importance of international banking activities and the increases in capital movements

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* Address given by Professor Stephen T. Zamora on March 10, 1994 as part of Fordham University School of Law Graduate Colloquium 1993-1994.

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1. The IMF and I were born the same year—1944—if one dates the IMF's birth by the date on which the IMF Articles of Agreement were signed (July 22, 1944), rather than the Agreement's entry into force (December 27, 1945). While this coincidence seems to have escaped the media, I have taken due note of it, and plan to celebrate (with the decorum fitting of an IMF-watcher) the achievements, if not the realization of all the dreams, of our first fifty years.


3. See Mary E. Footer, *GATT and the Multilateral Regulation of Banking Services,* 1953
that such activities occasion. Capital flows occasioned by international banking activities profoundly affect the ability of the Fund to achieve its goals. Nevertheless, the IMF has not seen fit to define its scope of activities to encompass more direct involvement, along with member governments, in the regulation of international banking.

As IMF studies themselves indicate, the operations of international banks and currency traders have an immense influence on the achievement of the goals of exchange rate stability, the integrity of the international payments system, and the duration and extent of balance of payments crises. It takes little effort, therefore, to read into the IMF Agreement a scope of authority that encompasses concern for the regulation of international banking operations to enhance exchange rate stability or to promote a secure and rational international payments network.\(^4\)

Given the propensity of international organizations to expand their jurisdiction—the Uruguay Round of the GATT is the most recent example of this—enlarging the Fund's scope of activities to encompass a more direct concern for the regulation of private banking activity would not be unheard of. The IMF's sister organization, The World Bank Group, now includes affiliated organizations—the International Finance Corporation, the International Centre for Settlement of Investment Disputes ("ICSID"), and the Multilateral Investment Guarantee Agency ("MIGA")—that deal directly with the activities of private enterprises.\(^5\) The IMF could take a much more active role in regulating international banking


\(^4\) The stated purposes of the IMF, which are drafted broadly, are listed in Article I of the IMF Agreement as follows:

(i) To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.

The Fund shall be guided in all its policies and decisions by the purposes set forth in this Article.


\(^{5}\) The International Finance Corporation takes equity interests alongside private investors in investments in developing countries. ICSID establishes a dispute settlement regime for disputes between private investors and host governments. MIGA guarantees private investments in member countries.
and international capital markets, by (1) providing a forum in which governments could meet to consider such regulation; or, more significantly, (2) pressing IMF member governments to adopt national or international mechanisms of regulation and control. The question remains whether it should do so.

The IMF is a cautious organization, reflecting the caution that characterizes central banking generally. It is a reactive, rather than a proactive agency; it responds to outside pressures for policy change more often than it proposes dramatic changes. I am not aware that the IMF itself has begun to consider its role in this regard, or that any government or group has done so. Indeed, calling upon the IMF to become more directly concerned with regulating the global banking network assures one of immediate opposition. First, the tide of financial deregulation and liberalization of capital movements has not subsided, and any mention of increased banking regulation is contrary to the trend. Second, to the extent that international coordination of banking regulation is considered an acceptable goal, other organizations—the Bank for International Settlements (through the Basle Committee on Banking Supervision), the GATT, or the OECD—monopolize the attention of commentators.6

Other organizations may be better suited to deal with issues of international banking regulation in general. This is not to say, however, that the Fund must ignore the subject if the regulation of international banking impinges upon the IMF’s ability to achieve the goals that are set out in its charter. In particular, the Fund should be sufficiently concerned about international banking operations, international payments and foreign currency markets to consider taking a more active role in pressing governments to undertake beneficial regulations, either individually or in concert. My purpose here is to suggest such a role, and some ways in which this might be done.

I will attempt to make a case for increased IMF involvement in regulating international banking and capital markets by first examining the principal international concerns of bank regulators at the present time. I will then relate these concerns to problems facing the international monetary system.

I. CONCERNS OF INTERNATIONAL BANKING REGULATION

During the 1980’s, the threat of widespread defaults on developing country debt monopolized the concern of bank regulators and treasury

6. "[T]he establishment of an appropriate international regulatory framework for trade in banking services is an ongoing, long-term effort. . . . Our analysis suggests that consideration should be given to continuing this work in the OECD or the GATT, either of which could serve as the forum for agreement on the appropriate principles and could participate in or coordinate the efforts of other specialized fora in arriving at harmonized rules where they are deemed necessary." Sydney J. Key & Hal S. Scott, International Trade in Banking Services: A Conceptual Framework 43 (Group of Thirty, Occasional Paper No. 35, 1991).
officials in many nations. This danger has subsided, but only after painful adjustments to many developing country economies that suffered through years of what economists euphemistically call "negative growth." The attention of banking, treasury and monetary officials has now shifted to new areas of concern. Like the developing country debt crisis, these new areas of concern arise out of a surge in activity in international financial markets due to developments that are not well understood and to which bank regulators are slow to respond.  

A. Foreign Exchange Markets and Trading in Derivatives

Due to the removal of many countries' restrictions on capital movements, and to dramatic technological advances in trading systems, foreign currency trading has become the hot international banking market of the 1990's. The world's foreign exchange markets have grown so large that they gulf individual national economies and central bank reserves. According to the IMF, worldwide foreign exchange trading (net turnover) exceeds 1 trillion dollars per day. Both banks and non-banks (i.e., multinational corporations, trading companies and investment firms) are important players in foreign exchange markets, attracted by the impressive profits to be earned in short periods of time.

The greatest increase in foreign exchange trading activity has occurred in the so-called financial derivatives market—a global market that has grown into a multi-billion dollar activity. Derivatives are financial instruments that derive their value from underlying economic indicators, including currencies. There is a wide variety of such instruments available for purchase either in over-the-counter markets or on financial exchanges: forward currency contracts, currency swaps, currency options, interest rate swaps, and futures contracts (interest and currencies) to name the most important. According to IMF figures, in 1991 the global derivatives market (outstanding exchange-traded and OTC contracts) totalled eight trillion dollars (notional value), or 140% of United States deposits led to a scale of sovereign lending that had not been seen previously. Only after many of the loans proved uncollectible did banking authorities begin to impose prudential regulations. See, e.g., International Lending Supervision Act of 1983, Pub. L. No. 98-181, §§ 901-13, 97 Stat. 1153, 1278-84 (1983) (codified as amended at 12 U.S.C. §§ 3901-12 (1992)). A similar pattern of market developments followed by financial crises can be found throughout the 1970's and 1980's. See International Monetary Fund, Determinants and Systemic Consequences of International Capital Flows 31-35 (Occasional Paper No. 77, 1991) [hereinafter Determinants and Systemic Consequences] (discussing measures to contain systemic risks in international financial markets).


In 1992, the aggregate credit exposure of ten United States banks due to derivatives trading was $170 billion, or 17.3% of their total assets. The bulk of this exposure (69%) was associated with exchange rate contracts.

One reason for the marked growth of derivatives trading is the relatively unregulated nature of the foreign exchange market. In an industry that is highly regulated, foreign exchange trading of major currencies, even when conducted by banks, remains a relatively unregulated activity. This is especially true in the United States, where foreign currency exposure of banks is not subject to any specific regulatory limitations (although currency positions are monitored).

The growth of the derivatives activities of banks has begun to concern bank regulators. The concerns have focused both on individual bank creditworthiness, as well as on systemic risks involved with an activity that is still poorly understood by bankers and bank regulators alike.

According to a recent IMF report,

[c]onsidering the phenomenal growth of the OTC derivative markets, the potential for systemic risk, and the fact that this relatively complicated subject is admittedly not fully understood by either senior bank managers or by senior regulators, it is not surprising that questions have been raised about the adequacy of the existing regulatory framework.

A significant side effect of the growth of foreign exchange and derivatives trading has been a rapid growth in gross international capital flows, particularly between industrialized nations. These flows reflect the

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10. See id. at 23.
11. See id. at 27.
12. See International Capital Markets. Part I, supra note 8, at 6-7 (comparing regulatory constraints on foreign currency-denominated investments by major financial institutions in selected industrialized countries).
15. See id. at 30; see also Determinants and Systemic Consequences, supra note 7, at 5-7, tbl. 2-3 (figures on net and gross capital flows during the 1970's and 1980's among major industrial countries).
short-term capital movements that characterize these markets. Because of such flows, capital markets in these countries are more closely linked than ever before. As we shall see, one result of such linkage is the potential for rapid and profound fluctuations in exchange rates.

B. Systemic Risks in the International Payments System

The growth in foreign exchange trading presupposes an international payments and clearing mechanism that can handle increases in the volume of transactions within these markets. Thanks to technological advances, the international payments system has been able to keep up with the demand for higher volumes of transactions without sacrificing the security of individual payments transactions. Nevertheless, banks and bank regulators have focused considerable attention on systemic risks in the international payments system—for instance, the risk that the insolvency of a large bank, unable to fulfill its payments obligations in accordance with international payments rules, may cause a domino effect that unsettles the payments system. This concern has preoccupied banking officials in all the industrialized countries, and has led to efforts by UN-CITRAL to harmonize the rules concerning potential liabilities within international payments systems. While the IMF’s purposes include assistance in the establishment of a multilateral payments system, it has remained outside this discussion.

C. Capital Adequacy

The external debt crises of the 1980’s, coupled with continued liberalization and deregulation of financial markets, produced another concern among bank regulators—that the capital requirements of major banks did not reflect the true risks facing the banks in a deregulated and internationally competitive market. As a result, the Basle Committee on Banking Supervision adopted a set of guidelines on capital adequacy of banks to which twenty countries now adhere. These guidelines, known as the Basle Accord on Capital Adequacy, were adopted with two major goals in mind: first, to require banks to maintain higher levels of capital reserves through maintenance of capital-to-asset ratios that are “risk-

16. See generally Amelia H. Boss, The Emerging Law of International Electronic Commerce, 6 Temp. Int’l & Comp. L.J. 293, 301, 304-07 (1992) (discussing the evolution of international electronic commerce and arguing that countries work together to develop a common understanding on which a universal international legal framework may be built).

17. The Basle Committee is an informal body of bank regulators from the Group of ten countries that meets under the auspices of the Bank for International Settlements (“BIS”) in Basle, Switzerland, to discuss common issues of concern. The full name of the Committee is the Basle Committee on Banking Regulations and Supervisory Practices.

based" (i.e., that reflect the real credit risks as well as risks of banks' (increasingly important) off-balance-sheet positions); and second, to establish a level playing field so that a bank based in one country will not receive a competitive advantage by enjoying a lower capital adequacy standard than a bank located in another country.\textsuperscript{19} These non-binding guidelines have been incorporated into national banking regulations for the Group of Ten Countries and a number of other countries as well.\textsuperscript{20}

One of the effects of the Basle Accord has been to focus on the credit and market risks associated with the financial derivatives described above, and to adopt rules establishing capital requirements for such transactions, which under previous rules often escaped such requirements. The Basle Committee is continuing to wrestle with possible amendments to the Basle Accord on Capital Adequacy to take into account the new risks associated with these markets, which are still not well understood.\textsuperscript{21}

D. Coordinated Supervision of Banking

While banking is an international industry, banking regulation is almost entirely national. This is true even though many banking activities have effects in multiple jurisdictions. Nevertheless, until recently there was no multilateral framework for coordinating international banking supervision.

The coordination of supervision by national banking authorities dates from the mid-1970's, when the Basle Committee (then known as the "Cooke Committee") adopted common principles for the supervision of banks' foreign establishments through a set of broad guidelines known as the Basle Concordat. Revised in 1983 and supplemented in 1990,\textsuperscript{22} the Basle Concordat provides guidance to authorities to avoid conflicts of regulatory supervision. As with the Basle Accord on Capital Adequacy, the Concordat itself is non-binding.

Even with the Basle Concordat, supervision of international banking is a rudimentary science. This became evident in 1991, in the aftermath of the Bank of England's declaration of insolvency of the Bank of Credit and Commerce International ("BCCI"), a global banking institution that was accused of illegal banking operations in many parts of the world. Despite the Basle Concordat, BCCI was able to escape prudential supervision by falling between the cracks of national regulation.


The effects of the BCCI case are still being felt, both in national law and in international coordination. The BCCI case proves that banking regulators in different countries in which a bank is operating should not assume that some other regulator was responsible for the overall health and solvency of a bank. In BCCI's case, Luxembourg, the location of BCCI's bank holding company, did not exercise significant regulatory authority because BCCI's operations were largely offshore.

In reaction to the BCCI case, the Basle Committee has reformulated the Basle Concordat to strengthen the notion of "consolidated supervision." Under this concept, banking authorities should ensure that international banking groups are supervised on a global basis by a home-country authority capable of providing responsible supervision of the groups global operations. Host-country and home-country supervisors would both approve any cross-border establishments, and home-country supervisors would have access to information on cross-border establishments.

Adjustments to the Basle Concordat notwithstanding, international banking continues to be characterized by an essential fact: banking is international, while regulation is national. These early attempts at coordination through the Basle Committee do not negate the fact that, even in their international activities, banks are subject to systems of regulation that vary from country to country, and sharing of information between national banking regulators has been the exception rather than the rule.

E. International Money Laundering

If financial derivatives are the growth industry of international banking, money laundering is the growth industry of banking regulation. Since the early 1980's, when the United States Treasury and Justice Departments began to attack organized crime's use of the financial system, there has been a proliferation of legislation in the United States as well as abroad, aimed at monitoring domestic and international payments. In addition, many countries, following the lead of the United States, have adopted money laundering legislation that criminalizes activity that was formerly (and in many countries still is) seen as normal banking behavior: helping persons move money from country to country to escape de-

tection by government authorities, without asking any questions of their customers.

At first, bankers reacted to these legislative and enforcement activities by summoning the principle of banking secrecy to absolve them of concerns over the use of the international banking system by criminals. This attitude has changed, however, in part out of compulsion. Bank regulators now expect banks to observe currency reporting and other laws that require the monitoring of payments, and to report to authorities information that they receive on suspicious activities. We are beginning to see increased international cooperation in this area, primarily on a bilateral basis through the conclusion of mutual legal assistance treaties between the United States and other countries.

There remains, nonetheless, a sense of uneasiness about the extent of banks' responsibilities to "know their customer" and to certify the underlying legality of their operations. Many bankers are pessimistic about the ability of government regulations to sanitize the banking system, especially when, it is assumed, illegal funds can always be shunted to an offshore banking haven that has more relaxed standards of behavior.

F. Trade in Banking Services

Although not a primary concern of banking regulators, issues regarding the establishment of a General Agreement on Trade in Services ("G.A.T.S.") that would liberalize trade in financial services are of great concern to bankers themselves. The Uruguay Round of GATT negotiations has concluded such an agreement, although it lacks a binding set of rules that would liberalize—to the extent desired by the United States and other banking powers—restrictions on cross-border trade in financial services or on the right of establishment.27 Nevertheless, the G.A.T.S. offers some hope for the conclusion of an eventual trade regime that would cover banking services.

G. The IMF's Non-Role in Bank Regulation

All of the regulatory concerns that I have mentioned have one thing in common: the lack of any mention of a role to be played by the IMF in dealing with them. This is true even in cases where the IMF is intensely interested in the phenomenon. For instance, the IMF has contributed intelligent staff reports on developments in international capital markets, and has called attention to the importance of these developments for the international monetary system.28 Nowhere mentioned in the reports is any role—even an indirect one—that the IMF might play in regards to these issues of banking regulation.

IMF-watchers will quickly add an obvious point: the IMF deals with

27. On the negotiation of financial services in the Uruguay Round, see generally Footer, supra note 4.
28. See supra notes 7-9, 33.
international monetary relations, not with private international banking
per se. The IMF monitors central banks, not private banks. It has no
role to play vis-a-vis the latter.

I would argue otherwise. If we look at the legitimate concerns of the
IMF—as I shall do in the following section—we shall see that the IMF
will be largely ineffective in achieving its goals unless it becomes more
actively engaged in helping governments to establish individual and col-
lective rules for optimum international banking regulation. In particular,
as I will argue below, the members of the IMF should agree to accept a
greater role for the Fund in providing a backdrop of rules to deal with
disturbances in international capital markets and in the international
payments system.

II. CONCERNS OF INTERNATIONAL MONETARY SYSTEM

The IMF's chief role in the world is to promote exchange rate stability
and to assist members in achieving equilibrium in their balance of pay-
ments. Another principal goal, contained in IMF Article I, is to promote
a liberal system of international payments.

If one were giving out report cards, what grade would you give the
IMF for having helped achieve these goals? Are exchange rates stable?
Do countries suffer balance of payments disequilibria? Is the interna-
tional payments system adequate to the needs of the world economy?

We should find an answer to these questions by looking at the current
concerns of the international monetary system—concerns that are linked
one to another. Equally important, they arise out of the same conditions
that create challenges for banking regulation.

A. Exchange Rate Instability

Exchange rate volatility, rather than exchange rate stability, has be-
come a fact of life in the world economy. To take just one recent exam-
ple, in 1992, the United States dollar appreciated against major
currencies by 7% through early March, depreciated by 10% through
early September, and then appreciated again by 14% by the end of the
year. By the end of 1992, the dollar had gained 25% against the British
pound and the Italian lira. In one brief week of trading during February
1994, the United States dollar depreciated against the Japanese yen by
10% (5% on one day alone), and the devaluation became a factor in the
trade war between the two countries. Within Europe, there was sufficient
pressure against some currencies to cause the temporary breakup of the
European Communities' exchange rate mechanism, which holds Euro-
pean currencies within a stable band.

It is hard for even the most positive IMF-watcher to argue that the
IMF's goal to insure exchange rate stability has been met. There are
several troublesome aspects to this conclusion. First, a worrisome level
of exchange rate volatility has marked the international monetary system
even though underlying economic conditions have been relatively stable. There is no worldwide recession, as in the 1930's, nor are the macroeconomic conditions of the major industrial countries that dissimilar. There may be a somewhat higher level of unemployment in Europe than in the United States, or slightly higher indices of inflation in one country or another, but the underlying economies are not as unstable as exchange rate movements might lead us to believe. This might give us some pause—how much more pronounced might exchange rate movements be if certain major countries did suffer from extreme recession or other economic (or even political) disruptions.

Second, exchange rate instability carries a cost for every society connected with the international system. A rapid depreciation of one currency against another can turn a profitable contract for the provision of goods or services into a major loss for one of the parties, despite the most careful calculations of the contracting parties. Exchange rate instability injects a major additional risk into the costs of engaging in international business.

Fortunately, we are told, the financial industry has invented a wide array of financial products that allow companies and even individuals to hedge their exchange rate risks. Many of these products are the same financial derivatives—currency options, swaps, etc.—discussed earlier. This “answer” does not negate the societal costs of instability, however, for the products themselves carry a cost or premium. Indeed, one might even view that sector of the financial industry that is devoted to the selling and trading of hedging instruments—all those highly paid bankers, all those computers and electronic trading links, all those profits earned by banks on foreign exchange trading—as the cost that the rest of society pays for the comfort of knowing that we will not wake up tomorrow morning to read in the newspaper that our future economic plans have been ruined because the dollar has sunk on world exchange markets. In a more perfect world—the simple world of the old fixed exchange rate system?—we didn’t need a closet full of expensive financial products to assure ourselves of a peaceful night’s sleep. A large segment of the personnel and equipment used for exchange trading could be put to work producing something in the real economy, like organizing vacation trips to Cancún.

Why have exchange rates been so much more unstable than the underlying economic conditions in different countries? The answer is as simple as it is disturbing: the same financial markets that allow us to hedge our exchange risks create the instability that requires their use. If these markets responded only to reasonable expectations of underlying economic conditions, they would not generate such pronounced movements in the values of currencies, because underlying economic conditions do not change so rapidly or to such an extent as exchange rates.

Paul Krugman, a professor of economics at MIT, has pointed out the costs to world economies due to exchange rate instability:
exchange-rate instability has resulted not only from reasonable mar-
et responses to changes in policies and underlying conditions but also
from failures in the international financial markets. In particular, the
traditional fear that floating exchange rates will be subject to destabi-
lizing speculation—to speculative bubbles that do real harm—is, un-
fortunately, strongly supported by the evidence of the 1980's.29

Professor Krugman questions whether foreign exchange markets operate
efficiently and rationally. "[T]he foreign-exchange market seems to make
two kinds of errors, . . . [i]t fails to recognize short-run trends, so that
forecast errors are serially correlated, and it loses sight of long-run equi-
librium, so that it runs away in temporary speculative bubbles."30

Under these conditions, what is the role of the IMF? How is the insti-
tution to achieve the goal of promoting exchange stability? The nominal
role of the IMF at present is one of "surveillance" of exchange arrange-
ments, in accordance with IMF Article IV, section 3. "Surveillance" is
one of many euphemisms that exist in IMF parlance that make it seem as
if there is substance to something that is in fact insubstantial. The
Fund's role at present consists of trying to understand how government
policies affect exchange rates, and making suggestions to the Group of 7
countries to adopt coordinated policies to try to mitigate fluctuations.31
There is little discipline or enforcement involved in this process.

Dissatisfaction with the results of this policy has given rise to many
proposals for reform of the exchange rate system—by the adoption of
target zones, pegged rates, closer macroeconomic coordination, etc.—but
few concrete proposals have surfaced that grant a significant role to the
IMF. A recent study by members of the IMF staff, who might be ex-
pected to promote a greater role for their organization, took a pessimistic
view of a more pronounced role for the IMF in administering an ex-
change rate regime with some kind of teeth. While acknowledging that
some observers had recommended explicit rules, "[a]mong practitioners,
however, the idea of moving away from informal processes to a set of
formal rules appears to have little support . . . . But the lack of support
for formal rules does not diminish the importance of quantitative
indicators."32

Lawyers may be overly enamored of rules, since they allow us to dis-
play our rhetorical and analytical skills. Even discounting this bias, how-
ever, it is hard to get excited about a "regime" that is founded on
something as uninspiring as "quantitative indicators."

30. Id. at 95.
31. See International Monetary Fund, Policy Issues in the Evolving International
Monetary System 28-31 (Morris Goldstein et al., Occasional Paper No. 96, 1992) (dis-
cussing the role of the IMF in promoting global economic stability by strengthening mul-
tilateral surveillance and policy coordination).
32. Id. at 30-31.
B. Short-Term Capital Movements

Closely tied to issues of exchange rate instability is the growth in short-term capital movements around the world. Simply put, the latter beget the former. In a series of recent studies, the IMF has focused attention on the growth in international capital movements. Most of the growth in net and gross capital flows has occurred between major industrialized countries. As the IMF has noted, these flows occur in a system of increasingly integrated capital markets:

[T]he integration of global financial markets has proceeded much more rapidly than that of goods markets—in part because the latter has been inhibited by protectionism. . . . [T]his growing integration of financial markets has important implications for the effectiveness of macroeconomic policies and systemic risks.34

The concern over capital flows relates directly to the concern over exchange rates. Liberal economics teaches that capital as a factor of production should move to where it can be used most productively, thus benefitting both savers and borrowers. This may be particularly true of long-term capital movements, such as foreign direct investment. Short-term capital flows, which characterize a large part of capital markets today, are another matter. As Paul Krugman has argued, such capital flows do not respond just to interest-rate differentials (i.e., to rates of return on capital, which should be a relative measure of productivity of capital), but also to speculative bubbles that may be contrary to efficient allocation of world capital.35 "The end result of the expectational failure of the foreign-exchange markets has been a huge, largely unrecognized misallocation of investment resources."36

Of course, industrialized countries are not the only ones adversely affected by the growth of capital flows due to the integration of world capital markets. Developing countries have also suffered the consequences of such flows, in particular by the phenomenon of large capital outflows, or capital flight.37 Many observers have noted, for instance, that the Third World debt crisis of the 1980's would never have occurred—or at least would not have been so protracted—if the debtor countries had not experienced such pronounced levels of capital flight. According to IMF figures, capital flight as a percentage of total external indebtedness of the most highly indebted developing countries varied from 42% in 1978 to

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33. See, e.g., Determinants and Systemic Consequences of International Capital Flows, supra note 7, at 4-19 (studying trends in international capital flows among industrial and developing countries during the 1970's and 1980's).
34. Id. at 7.
35. See Krugman, supra note 29, at 86-94.
36. Id. at 94.
37. It is interesting to note that, in the case of developing countries, it is more common to see the use of the pejorative term "capital flight," whereas industrialized countries undergo "large outflows." Rarely does one see a discussion of "capital flight" associated with the United States, for instance, even in the face of large, sustained movements against the dollar.
51% in 1988. In other words, remove capital flight and you remove the debt crisis.

Capital flight may carry a negative connotation, but most people still believe that capital movements—even short-term capital movements—are good. For one thing, they represent the “discipline of the market” in an international monetary system that no longer faces the discipline of a fixed-rate regime. Capital movements may be seen as votes in favor of or against particular economies, rewarding “good economic behavior” and penalizing bad performance.

The discipline of the capital markets may, however, be like the discipline administered to a youngster by a cranky old uncle: it may be overly harsh, arbitrary and irrational.

The relationship between capital movements and exchange rate instability is clearly established. What is the IMF’s role in assisting members to deal with the consequences of capital movements? Again, the IMF’s role is largely a non-role. In establishing a code of conduct for international payments, the IMF Articles of Agreement were drafted to promote free movement of funds for the payment of current international transactions—i.e., for payment of goods and services. Few people question the importance of the IMF’s rules in this regard. When it comes to capital movements, however, the IMF’s stance is more schizophrenic: the IMF’s Articles permit governments to control capital movements so long as such controls do not interfere with freedom of payments for current transactions. Despite this broad permission of capital controls, the IMF appears to endorse policies of member governments that include as a goal the liberalization, if not elimination, of capital controls. Since the IMF has very little authority to direct the implementation of such a goal, it has largely remained on the sideline while other players—especially private players, such as banks and investors—determine the outcome of the capital movements game.

The lack of definite rules concerning short-term capital movements is not surprising when one considers the genesis of the IMF. When the IMF Agreement was adopted, short-term capital movements played a less important role in the international economy than they do now. The IMF could concentrate its efforts on eliminating restrictions on current transactions, since these were the transactions that monopolized the foreign exchanges. This is no longer the case, and transactions in the capital account of the balance of payments now have more to do with balance of payments equilibrium and exchange rate movements than do current

38. See Determinants and Systemic Consequences, supra note 7, at 84, tbl. 1.
39. See IMF Article VI, § 3; Article VIII, § 2(a). The IMF rules on exchange controls and payments restrictions are well summarized in Richard W. Edwards, Jr., International Monetary Collaboration 380-490 (1985).
40. See the views expressed in International Monetary Fund, Liberalization of the Capital Account: Experiences and Issues (Donald J. Mathieson & Liliana Rojas-Suárez, Occasional Paper No. 103, 1993).
transactions for payments of goods and services. It is harder today to justify the IMF's equivocal nature concerning capital movements.

C. Integrity of the International Payments System

As stated at the outset, one of the IMF's goals is to promote a secure system of multilateral payments for current transactions. The IMF has made a concerted effort to convince governments to remove exchange control restrictions that inhibit the payments system. Even so, many governments do still impose exchange controls on current transactions, as evidenced in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions, which lists the restrictions of individual members.

Other aspects of the security of the international payments system have escaped the IMF's concern. Even as many governments have relaxed exchange controls that hamper international payments, other governments have initiated new controls. This latest wave of controls comes from an effort, begun by the United States government, to try to attack illegal activities—organized crime and drug trafficking in particular—by detecting the use of the international payments system for transferring funds that are the product of illegal activities. In the United States, money laundering legislation and currency transactions reporting laws place great emphasis on the monitoring of payments—i.e., on exchange controls. (Keep in mind that exchange controls include regulations aimed merely at monitoring rather than preventing payments). Other countries have since established their own money laundering laws, and we are beginning to see intergovernmental efforts to promote regulation of the payments network for these purposes. Despite the relevance of these activities to the functioning of the international payments system, the IMF has little to do with this phenomenon.

Finally, as mentioned previously, bankers and bank regulators continue to be concerned about the possibility of systemic risks in the international payments system due to the possible consequences of default by an account party in a payments transaction within one of the world's payments clearing systems. Here also, the IMF has not been drawn into the discussion of possible rules that might be generated to mitigate such risks.

III. The Relationship Between Banking Regulation and IMF Goals

If we compare the issues of international banking regulation, discussed
in Part I, with the principal concerns of international monetary relations discussed in Part II, it is not difficult to see that the two are closely connected. International banking activities, as beneficial to the world economic growth as they may have been, have also helped create problems in the international monetary system. Activities in banking and capital markets have helped generate the instabilities and disruptions associated with exchange rates and balance of payments equilibrium. The phenomenal growth of foreign exchange trading and short-term capital movements have brought periods of severe exchange rate instability. The extension of trade in financial services through networks that reach into all corners of the world challenge the efforts of domestic monetary authorities to control money supplies and to regulate domestic capital markets. The creation of a low-cost international payments and deposit system promotes international business, but it also makes it easier for companies and individuals to evade taxes and avoid fiscal and monetary controls established by national authorities.

It is true that some of these disruptions and instabilities may emanate from underlying economic and political conditions, rather than banking operations per se. The global banking network is merely the circuit in which market forces operate; it is the latter that should attract attention, through responsible monetary policies. The need for responsible fiscal and monetary policy is not a reason not to regulate the circuit, however. To use an analogy, traffic accidents are caused by bad drivers, not by superhighways; nevertheless, that is not a reason to refrain from regulating the construction of highways, or the activities of those that use them. The ingenuity of bankers in creating and exploiting new financial products and new markets even before they are well understood contributes to the degree of uncertainty that characterizes the international monetary system. As the creators of a financial superhighway, bankers should expect that governments, individually and collectively, will want to regulate international traffic on that highway. Since their activities profoundly affect the health of the international monetary system, bankers might even concede that the IMF might have something to say about what they are doing.

My central argument is this: If it is true that banks are part of the problem, then the IMF cannot continue to ignore the regulation of private banking activities if it is to play a role in alleviating disruptions in the international monetary system. My thesis is really twofold: first, IMF member countries should accept a greater role for the IMF in creating the necessary conditions for exchange rate stability and the smooth functioning of international capital markets and payments mechanisms. Second, the IMF will only be able to accomplish these goals if it becomes more actively involved in the regulation of the global banking network. The IMF should provide a forum through which national banking authorities, working with its staff, can arrive at optimal systems for the regulation of international banking, international capital markets, and in-
ternational payments mechanisms that insure greater stability of the international monetary system as a whole.

Until now, the IMF has largely remained on the sideline while international banks have helped to generate monetary chaos. When the situation becomes intolerable, the IMF is then called in to help bail out the countries that are on the verge of financial ruin. The Third World debt crisis of the 1980's was a good example of this. By the early 1980's, as syndicated eurodollar lending expanded, many bankers viewed the IMF as a largely irrelevant institution. After all, the IMF no longer administered a fixed exchange rate system, and its function of providing financial assistance to countries was increasingly displaced by the brave new Eurodollar market. We all know what happened: the Eurodollar loans generated a debt crisis, and by 1983 the banks were all too willing to engage the IMF and World Bank in helping them to deal with the mess through IMF-endorsed adjustment measures.

We should question the wisdom of the IMF's non-role in the debt-crisis prior to 1982, just as we should question today the non-role of the Fund in dealing with disruptive capital markets. To use an analogy, if the IMF is going to be asked to help put out fires, shouldn't it take a greater role in fire prevention?

It is not as if the IMF does not recognize the dangers inherent in a monetary system at the mercy of deregulated banking and capital markets. IMF studies have pointed to a pattern of financial crises preceded by the introduction of new financial instruments or new market conditions that are not well understood—in short, by the conditions that now prevail, as shown in Part I of this Article. Yet no one seems to be suggesting that the IMF take a more active role in regulating these markets for the benefit of the monetary system as a whole.

The easy response to my suggestion might be that "this is someone else's job." The IMF is supposed to handle relations between central bankers, not private bankers.

Unfortunately, no other organization has asserted a satisfactory role to control the negative effects produced by international capital markets. The Bank for International Settlements, under whose auspices the Basle Committee on Banking Supervision operates, has served as the principal forum to date for the coordination of bank regulatory policies. Yet the Basle Committee has done very little to date to subject international capi-

44. See Determinants and Systemic Consequences, supra note 7, at 30-37.
45. In a recent report, the United States General Accounting Office recognized the need to strengthen international banking supervision, and recommended enhancing the role of the BIS as the principal forum for this purpose. See United States, General Accounting Office, Report to Congressional Committees, International Banking: Strengthening the Framework for Supervising International Banks (GAO/GGD-94-68, March 1994) 3-4, 45-47. The GAO report found little support for a strong supranational authority. See id. at 3, 46. However, the Office of the Comptroller of the Currency, which supervises national banks in the United States, questioned both the appropriateness of the BIS as forum, and the lack of support for supranational authority. See id at 49, 73.
tal markets and international banks to measures of control that would guard against disruptive effects of short-term capital movements.

Furthermore, the BIS is an exclusive club representing the central banks of the most highly industrialized (Group of Ten) countries. While the Basle Committee includes the home country regulators of the world's largest banks, it does not represent the views of all countries that would be affected by more rigorous regulation of international capital markets. The OECD—another organization that has over the years dealt with issues of capital movements—is a similarly exclusive organization, although its membership is expanding somewhat.

By contrast, the IMF has become—after the inclusion of the republics of the former Soviet Union—a virtually universal organization, with a membership of 180 countries. As such, it can hope to insure a universal observance of any rules that might be adopted. While the IMF is a universal organization, its decision-making structure—based on a weighted voting system—protects the countries with the greatest share of international banking activity by allocating decision-making power according to relative economic power.

As mentioned previously, the IMF has focused its concern on the need for coordination of international capital markets. A 1991 report by IMF economists stated: "[t]he responsibility to calm financial markets in periods of turbulence may be especially important today, as a result of increased integration of global financial markets." Nevertheless, the report cautioned against throwing "'sand in the wheels' of the international capital markets by accepting restrictions . . . on capital flows." While refraining from suggesting a role for the IMF to play in the process, the report focused on the need for "[j]oint undertakings by the public and private sectors . . . along with a coordinated approach by central banks and other regulatory bodies." However, the report fell short of recommending that the IMF play a definite role in this endeavor.

The IMF's reluctance as an institution to assume an active role is not surprising. As stated earlier, the IMF is a reactive organization rather than a proactive one. The international civil servants in the IMF do not tend to define new roles or activities for the organization, but rather respond to pressures from outside forces, primarily from the IMF's largest members.

What specific functions should the IMF undertake? Let me mention several, keeping in mind that each of these deserves much more detailed treatment than I can give here.

First, the IMF should organize itself as a forum in which the regulation of international capital markets becomes a subject of discussion by governmental and intergovernmental agencies. Because the regulation of

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47. Id. at 16.
48. Id. at 17.
international banking is closely related to its primary goals, the IMF is the most appropriate intergovernmental organization to provide such a forum. In other words, it is in the IMF's strong interest to take a strong hand in this endeavor.

To begin with, the forum could be as informal as the Basle Committee on Banking Supervision. It need not include all IMF members in all discussions, but since the IMF enjoys a global membership, it can afford representation to members from outside the BIS fraternity of industrialized nations. Such representation is important, since a greater degree of capital market regulation could be defeated by banks escaping to non-regulated offshore banking centers. By making participation in a regulatory scheme part of the price of continued enjoyment of IMF membership, worldwide compliance with agreed regulations would be more easily assured. Eventually, the formation of an organization affiliated with the IMF may be needed, in order to specialize in the issues discussed here—the confluence of international banking regulation and international monetary issues.

Second, the IMF should exercise some authority in pressing, within such a forum, for a regime of regulated international capital markets. A great deal of study is now underway, in universities, governments and organizations like the IMF, on the optimal degree of capital market regulation. My own bias in this regard should be clear to you by now: free and deregulated markets may be positive goals for the allocation of non-banking goods and services, but financial markets—especially the banking market, to which we entrust public savings—should be highly regulated, within parameters that allow the interplay of market forces without inflicting on society the abuses that can accompany normal human urge towards unsettling speculation: speculative bubbles, market crashes, and the evasion of fiscal and monetary laws.

One possible role for an IMF-sponsored system of regulation would be to create a sort of international "FDA." In the United States, the Food and Drug Administration must give its approval to new drug products before they are put on the market, and may order the removal of products that are deemed harmful to health. Products that lack FDA approval simply cannot be sold. A similar process could be used to create a system of tested international financial products that meet societies' needs for investments and hedging, but which do lend themselves to the harmful side effects of instability and speculative bubbles.

Third, the IMF should work to convince the world banking community and its member governments to accept a compromise that, in my opinion, will eventually be generally accepted by the world banking community. The compromise is this: there must be a trade-off between free-

49. Cf. International Monetary Fund, Characteristics of a Successful Exchange Rate System, supra note 9, at 16 ("Yet there is always an incentive for some country to capture more of the world's business by not imposing the tax [of increased regulation].").
dom of international capital movements and banking secrecy. The price to pay for being able to shift money around the world in a low-cost and secure international payments system is a willingness to allow governments to track international payments and to pry into the beneficial ownership of bank deposits. The possibilities under conditions of space-age banking for abuse of strict banking secrecy laws are too high to permit the continuation of a principle adopted before the creation of a global banking network. It should be possible to find legitimate standards for governmental intrusion while also developing standards to ensure a proper level of financial privacy.

Such a tradeoff is already occurring, as shown above, by increased intergovernmental cooperation over laws designed to deter money laundering and prevent the use of the international payments system by drug traffickers. The IMF's Articles of Agreement, in one of the least cited provisions of the entire IMF charter, provide explicitly for such cooperation. Here again, the inclusiveness of IMF membership is important to the creation of a system of regulation that cannot be easily avoided by the use of unregulated offshore banking centers. Compliance with IMF-sponsored regulations on monitoring would be the price to pay for access to the international payments and clearing network that is a necessary condition for the efficiency of modern banking operations.

With the advent of global banking, we are witnessing the gradual creation of a network of depository institutions linked by sophisticated telecommunications and computer systems. Until now, it has been assumed that the creation of such a network makes government regulation impossible, as if the ease of capital movements to all corners of the world dooms the possibility of control. I suspect, however, that we are merely witnessing an intermediate stage in the creation of global banking. At some point in the not-too-distant future, global banking will be carried out by well-supervised banking institutions that will be required to participate in a single network of international payments and deposits—a closed system to which all reputable banks would have to belong.

There is no reason why the linkages provided by S.W.I.F.T., CHIPS and other electronic payments mechanisms in the international system could not be arranged into a single, closed network to which all banking participants and their governments would have to adhere. Such a network could help ensure security, but would also significantly enhance the effectiveness of government regulation, through the tracing of payments and deposits. Increasingly, the use of physical currency—banknotes, traveller's checks, etc.—is an inadequate substitute in legitimate business

50. See text accompanying supra note 43.
51. See IMF Article VIII, § VIII (2)(b) ("In addition, members may, by mutual accord, cooperate in measures for the purpose of making the exchange control regulations of either member more effective, provided that such measures and regulations are consistent with this Agreement.").
transactions for electronic transfers of funds. International capital movements will increasingly occur over the international payments network, subject to increased monitoring.

If such a system were endorsed by the IMF, it would not be difficult to isolate “haven” countries that would otherwise be used to defeat the more regulated payments network of the official, “closed system.” Governments that refused to participate would suffer the effect of being excluded from the benefits of using IMF facilities.

The dangers of abuse of governmental authority over such a payments mechanism would not be insurmountable. Experts are already beginning to address the issue of international standards for regulating financial privacy, and just as the world trading community administers rules that penalize countries for unfair trading practices, the IMF-sponsored payments network could similarly administer rules to prevent the abuses for which banking secrecy was initially invented.

In short, freedom of capital movement benefits the world economy. But a system of unregulated capital markets, in which funds can be transferred under the veil of bank secrecy, has the potential to undermine the governmental authority necessary to ensure sound economies, in individual nations as well as in the world as a whole. In the international monetary system that now exists, the IMF is still the best hope to inject an element of discipline into international banking and capital markets in order to achieve stability in the world economy.

52. See, e.g., Joel R. Reidenberg, The Privacy Obstacle Course: Hurdling Barriers to Transnational Financial Services, 60 Fordham L. Rev. 137 (1992) (examining the challenges to transnational financial services resulting from national regulation of information processing and arguing for a convergence on standards of fair information practice through legal, technological and societal techniques for specific contexts).